Investment Commentary

EQUIUM CAPITAL

December 2018

Searching for Santa Claus

If there was ever any doubt as to the importance of liquidity and credit, the last 2 months of asset price performance should have laid those to rest. Often overlooked by bottoms-up fundamental investors, they are two of the most critical factors out there and play a central role in Equium Capital's investment process.

As global Central Banks begin reducing liquidity by unwinding asset purchase programs and increasing interest rates, there has been a notable decline in financial conditions (Chart 1). This trend has several implications, not least of which are slower economic growth and lower valuations due to higher discount rates. Therefore, it should be no surprise that this change in monetary policy brought about a swift decline in global equity markets and a fairly severe sector rotation away from cyclicals and towards defensives (Chart 2).

We also find ourselves disagreeing with many who are drawing parallels between the current downturn and the sharp pullback we saw in February. Although there are similarities, the key difference is that equities are not the only asset class at the party this time around. More important to our view of the economic cycle, credit spreads at both the high yield and investment grade level have widened to their highest levels since 2016 (Chart 3). Some of this has undoubtedly been the result of the steep pullback in oil prices combined with the high weight of energy companies in the High Yield index. However not all of the move can be explained by oil. Given cycle-high levels of corporate debt and cycle-low covenant quality combined with our outlook for higher interest rates and reduced liquidity, we expect credit spreads to continue to widen. Regrettably, this toxic combination most likely results in slower economic activity than consensus expects.

To be sure, several leading indicators pointed to this weaker outcome some time ago. Global manufacturing PMIs peaked way back in January and ECRI's weekly leading index growth rate topped in February; however, in spite of declining indicators U.S. earnings growth is tracking toward +24% this year on the back of massive tax cuts and record share buybacks. Considering the fiscal stimulus alone, it is no surprise American markets have held up better even as global economic momentum waned and earnings revisions deteriorated. Indeed, the market reality is dramatically less rosy than U.S. equities suggest and according to a recent Deutsche Bank report, 2018 has seen the highest number of asset classes post negative returns since 1901!

Chart 1 | Global Financial Conditions (3 Years)
source: Bloomberg, Equium Capital

Chart 2 | U.S. Sector Rotation Q4-to-date
source: Bloomberg, Equium Capital

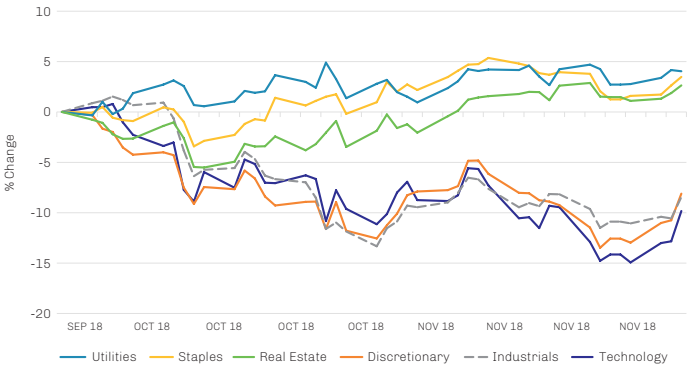
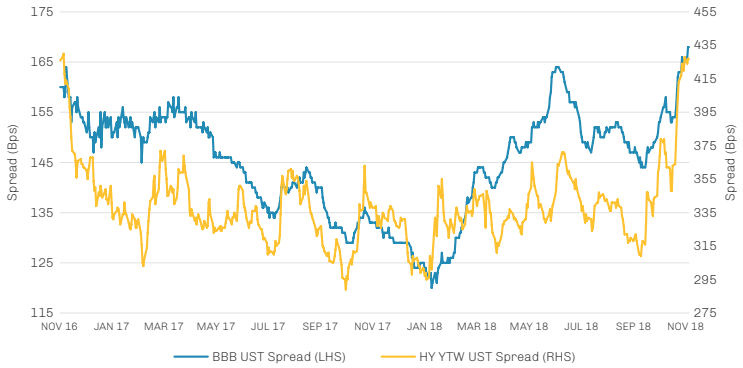


Chart 3 | Investment & High Yield Credit Spreads (2 years)
source: Bloomberg, Equium Capital



Equium Capital Management Inc.
36 Toronto Street, Suite 1170, Toronto, ON M5C 2C5
(416) 304-9364 | info@equiumcapital.com

Looking to 2019, the rate of change in many leading indicators and conditional factors continue to point to slowdown. That said, what's critical to us is that while slowing, the data are not yet pointing to recession, with many models estimating only 10-25% odds of a recession within 12 months (Chart 4). This would make the recent and sharply defensive sector rotation appear overdone for now.

Earnings estimates are also likely to decline as a result of higher labour costs, tariffs, interest rates and USD strength, resulting in roughly mid-single digit EPS growth for the S&P next year, lower than the ~10% that consensus currently expects. Again, the important distinction here is that while slower, we still expect earnings growth to be positive overall, which is not consistent with recession.

Tactically, our process continues to advise caution as we have not yet witnessed a wash out in sentiment or volume that could indicate a near-term bottom for markets. Moreover, recent positive catalysts including more dovish Fed rhetoric, a trade war ceasefire and an OPEC supply cut agreement should have underpinned growth expectations and quelled fears of excessive monetary tightening. The fact that credit spreads continued to widen and markets sold off further in the face of such positive developments is not reassuring.

Although the negative rate of change we are witnessing across many critical indicators forces us to question our outlook (Chart 5), the absolute growth trends and levels remain modestly positive. This slowing-but-still-growing backdrop has us looking for selective investment opportunities that are more likely global than U.S., such as our recent addition of Brazil, as well as in out-of-favour but fundamentally well-supported areas, such as MLPs.

We have never been comfortable with speculating on bottoms while fundamentals are still deteriorating, which argues for continued caution. Going forward, we expect a continuation of choppy markets until such a time as either economic data and financial conditions inflect higher or the leading indicators begin to confirm recent price action for a more material downturn in economic growth. In the meantime, Santa's sleigh insurance better be fully paid up.

Chart 4 | NY Fed U.S. Recession Probabilities (20 years)
source: Bloomberg, Equium Capital

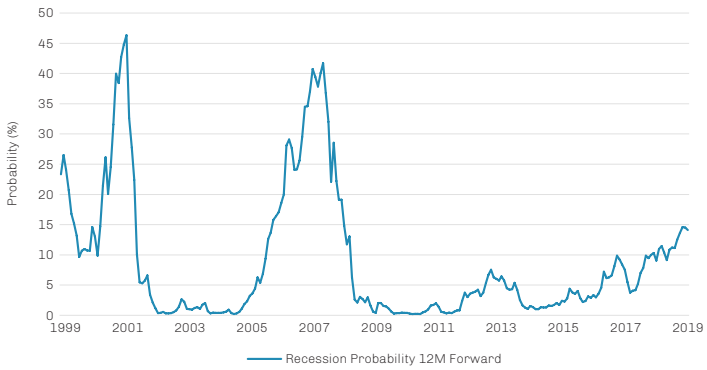


Chart 5 | Global Economic Surprise Index (1 Year)
source: Bloomberg, Citigroup, Equium Capital

Table 1 | Investment Recommendation Snapshot
source: Equium Capital

	Sector	Region
Overweight	Cash Energy Health Care	U.S. Brazil
Underweight	Credit Financials Discretionary	Australia Canada United Kingdom

Adam Murl, CFA
Portfolio Manager/Head of Research
adam.murl@equiumcapital.com
(416) 304-9359

Equium Capital Management Inc.
36 Toronto Street, Suite 1170, Toronto, ON M5C 2C5
(416) 304-9364 | info@equiumcapital.com

Cameron B. Hurst
Chief Investment Officer
cameron.hurst@equiumcapital.com
(416) 304-9360